



(From left) Stephen Chan, Edward Chow and Paul F Winkelmann

### Three-pronged approach to reform

Mr Chan continues, 'All the hard work has been organised and put together in a far-reaching report released by the Institute in March 2005 entitled 'A Case for Professional Liability Reform in Hong Kong'. This report is available at ([http://www.hkicpa.org.hk/professionaltechnical/liability/liability\\_reform.pdf](http://www.hkicpa.org.hk/professionaltechnical/liability/liability_reform.pdf)).

In it, the Institute has outlined a comprehensive, three-pronged approach to tackling the issue. The report's recommendations include:

- introducing proportionate liability
- amending section 165 of the Companies Ordinance to remove the prohibition against auditors
- contractually limiting liability with clients in respect of audits
- introducing LLPs.

'Our view is that each of these three recommendations are separate and achieve different things but we need all three to have a balanced liability environment,' says Paul F Winkelmann, chairman of the Institute's Liability Reform Working Group, which authored the report.

For years, the Institute has advocated each of its three recommendations, but this is the first time that they have been grouped together as a package. The report, which also has the endorsement of the Hon Mandy Tam, the profession's representative in the Legislative Council (LegCo), has been widely distributed to all local and overseas stakeholders, including the Financial Secretary, the Secretary for Justice, the Institute's members, regulatory authorities, the Financial Services and the Treasury Bureau and the LegCo Panel on Administration of Justice and Legal Services, which has met to discuss the issue.

### A matter of urgency

The Institute is urging the Hong Kong Government to adopt the reform measures as soon as is practicable. Mr Chow believes the introduction of a draft bill on LLPs, considered the first step on the road to reform, could be a reality this year. The Law Society of Hong Kong has already drafted the proposed legislation, supported by the Institute, which would allow firms in the

# Liability reform is the top priority for Hong Kong Institute of CPAs

Without liability reform, Hong Kong's status as a premier financial centre is under threat. Little wonder the Institute is working hard to get such reform on the books

The nightmare scenario is a mega-lawsuit that could wipe out a Big Four firm. Mid-sized and smaller firms are equally at risk. This increasingly worrisome possibility has led the Institute to make liability reform its top priority, says Institute's president Edward Chow.

Without reforms, Mr Chow adds, not only are accounting firms being kept on tenterhooks but Hong Kong's position as a global financial centre is in jeopardy. 'The threat is real and because of insufficient protection, or firewalls, protecting the accounting profession, auditing firms are turning down new work where the risk and reward is considered to be imbalanced. This has begun to hurt the operation of our financial markets on new listings,' Mr Chow declares.

Stephen Chan, the Institute's executive director, adds, 'The Institute's Professional Risk Management Committee has since 1996 been advocating an equitable system of liability in Hong Kong. The work involves a whole spectrum of areas, including reviewing tort reforms in overseas jurisdictions, seeking legal advice and considering various alternatives, such as modified proportionate liability, limitation by contract, statutory capping, limited liability partnerships (LLPs) and others.' As a result, the Institute has made a number of submissions to the Government over the last few years on the need for professional liability reform in Hong Kong.

territory to establish LLPs. 'Assuming the Panel on Legal Affairs has no major problems, we think the Department of Justice will formally present the bill to LegCo. This should be as soon as possible,' he says.

LLPs differ from the traditional system of joint and several liability, under which accounting firms and other professionals currently operate, in one crucial way. With joint and several liability, all partners in a firm are equally liable if a plaintiff's case succeeds – even if only one was at fault. This means that after the firm's insurance pays the claim and all of the firm's assets are seized, the partners' personal assets can also be subject to seizure. However, an LLP protects the personal assets of the innocent partners, even if the firm itself doesn't survive.

Proportionate liability and contractual limits on liability, both considered vital elements of the reform process, are facing a tougher test. Proportionate liability is a means of equitably dividing responsibility for a plaintiff's loss by a system of apportionment in which the guilty parties pay according to their degree of blame. For example, if directors are responsible for 90 per cent of the losses, they would have to pay 90 per cent of the costs. If auditors are responsible for 10 per cent of the losses, they would be responsible for that 10 per cent.

'This is a very important concept,' says Mr Winkelmann, 'since at the moment people choose not to pursue directors because they may have limited resources. And even if the directors are heavily involved, they get away. But there is a perception that auditors have financial backing and so they go after them whether or not they have contributed to the liability.'

'Many years ago, the concept of joint and several liability operated reasonably well in the relatively simple and straightforward world that people lived in. Today, if you look at any one transaction, there are several parties involved. These are bold, sophisticated players, many of whom are going into transactions with their eyes open. It doesn't seem fair to apportion liability on one party when all parties have some responsibility for what happened.'

## 'What we do know is that the size of the lawsuits and their life threatening aspect are now far greater than ever before.'

If LLPs protect the innocent partner, he says proportionate liability offers a way of protecting the firm from unfair money grabs. Objective decisions on liability percentages would be made by the courts.

### No threat to public interest

He stresses that the public interest would be protected under the Institute's modified system of proportionate liability, which includes a number of exceptions where the full force of joint and several liability would still apply. Examples are personal injury actions as well as cases where the defendant has been found by the court to have caused damage or loss as a result of fraud, dishonesty or willful default.

Mr Winkelmann emphasises that proportionate liability would not deprive anyone of their rightful claims for redress if they have been wronged. It would merely fairly assign the responsibility to those who are judged to be at fault. 'We are not attempting to shift the risk to anyone else. If we have a risk, that stays with us. The public has a right of recourse but it should not be to one party – it should be to all parties that they have lost money from, he maintains.

In 2003, the Standing Committee on Company Law Reform (SCCLR) examined the issue of proportionate liability. At the time, the SCCLR felt it was not possible to distinguish auditors from other professionals with regard to professional liability and a suggestion was made to refer the matter to the Law Reform Commission for further study.

### Regrouping

But that has hit a snag. 'Unfortunately, we have recently found out that in order to refer work to the Law Reform Commission, two parties must jointly refer it – the Secretary for Justice and the Chief Justice. And so far, they haven't,' says Mr Winkelmann. The

explanation the Institute received from the Solicitor General's Office was that due to liability pressures from associations representing physicians, lawyers, dentists, taxi drivers and others 'the issue was too big and must be looked at on a much wider basis'.

Disappointed but not defeated, Mr Winkelmann says the Institute had only hoped that the Law Reform Commission would take the matter under consideration. 'We weren't asking that anyone make a decision. We were simply asking that it be referred to the body that has to debate it before we can take it any further. We don't think that's unreasonable,' he adds.

The Institute's next step is a campaign to drum up support for sending the matter to the Law Reform Commission. 'We need to regroup and understand whom we need to speak to. We need to do quite a lot of lobbying of legislators. We need to lobby the administration. We need to lobby our friends in the administration. We need to see to what extent they need to help us and support us,' Mr Winkelmann says.

Moving forward on proportionate liability and contractual limits on liability is urgent, he contends, in light of recent changes in the financial landscape caused by the rapid opening up of China and the globalisation of financial markets. He says that large IPOs from the Mainland and the financial interconnectedness of countries and players make the prospect of a catastrophic lawsuit too great to ignore.

'When you consider that state owned enterprises, which are enormous enterprises in China, are coming to the Hong Kong marketplace and raising funds in the billions of US dollars, nobody in Hong Kong could withstand a lawsuit on that scale,' he points out.

Mr Chow also notes that countries that compete with Hong Kong and have

instituted liability reforms are now in a better position to take business away from Hong Kong. According to the Institute's March paper, Australia, Canada, the US, the UK and other European Union countries have/will have some combination of LLPs, proportionate liability and contractual liability limits, or all three.

'If a Mainland Chinese company wanting to list in Hong Kong goes to a Hong Kong firm of auditors and is turned down, that company can go to London which is welcoming Chinese companies with open arms. The London firm, which may be a brother or sister firm of one of Hong Kong's Big Four, can take on the work comfortably because they have liability protections. That means Hong Kong loses out, he explains. 'This undermines the growth of Hong Kong as a major international financial market. It's as simple and fundamental as that. Hong Kong prides

itself on the rule of law but compared to other common law jurisdictions, Hong Kong is behind in reforms and modernisation.'

Mr Winkelmann shudders at the thought of what would happen if another international accounting firm should fail as spectacularly as Arthur Andersen, the accounting firm for scandal-ridden Enron. 'If a Big Four firm failed, no regulator in the world would allow the Big Three. They would be forced to split into six firms. The financial markets would also be severely affected. The loss of confidence would be tremendous. The ability to find service providers would be very difficult,' he says.

### Increasing risk

Predicting when, where or why such a lawsuit would be filed is impossible but the chances that one will occur are increasing. 'The potential combinations are endless. You could be doing work in

Hong Kong on behalf of China entities and the lawsuit could come from the US,' he warns. 'What we do know is that the size of the lawsuits and their life threatening aspect are now far greater than ever before.'

### A level playing field with major jurisdictions

Mr Chan sums up by saying that what the Institute is asking for is to have a level playing field with other major jurisdictions. Currently, Hong Kong is lagging seriously behind. Hong Kong only has corporate practices but does not allow proportionate liability, contractual liability limits, statutory liability capping, and LLPs. Professional liability reform is now vital to safeguard Hong Kong as an international financial centre.

ANDREA PAWLYNA IS A BUSINESS JOURNALIST

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Author: John Broome

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